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In the Supreme Court of the United States

October Term 1945
No. 47

TALBOT MILLS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

UPON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States.

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TALBOT MILLS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

BRIEF FOR THE PETITIONER

Talbot Mills, a Massachusetts corporation, respectfully submits this brief upon the merits in the above entitled cause.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 93) is reported in 146 F. 2d, 809. The opinion of the Tax Court (R. 73–81) is reported in 3 T.C. 95.

JURISDICTION

A. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Section 347 (a)).

B. The case involves the construction and application of Internal Revenue Code, Section 23 (b), providing that in

computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness (with an exception not material). This deduction has been denied to the Petitioner in violation of applicable principles of law, as hereinafter set forth. That the issues are substantial may be assumed in view of the granting of the writ.

C. The decision of the Circuit Court of Appeals was entered December 22, 1944. Certiorari was applied for March 22, 1945 and granted April 30, 1945. (R. 104)

STATEMENT OF THE CASE

The Respondent determined a deficiency in Petitioner's Income and Excess Profits Tax liability for the Petitioner's taxable (fiscal) year ended September 30, 1940 (R. 57–59). Petitioner applied to the Tax Court of the United States for a redetermination of the deficiency (R. 3–6). The Tax Court sustained the Respondent's determination of a deficiency (R. 73–81, 85). Petitioner duly sought review by the United States Circuit Court of Appeals for the First Circuit (R. 86–7). The Circuit Court of Appeals, one judge dissenting, affirmed the decision of the Tax Court (R. 93–106).

The deficiency was based upon the disallowance by the Respondent of $40,000 which the Petitioner had deducted as interest upon its return (R. 59, 73, 93–94). This was interest on the Petitioner's issue of registered notes, outstanding in the aggregate face value of $400,000 (R. 74, 95). It was stipulated that the item of $40,000 was properly accrued for and on account of the taxable year in question (R. 14–15). The issue was whether such item, so accrued, constituted interest deductible within the meaning of Section 23 (b) of the Internal Revenue Code (R. 59, 3–6, 14–15, 73, 78, 97).

The full text of a specimen of Petitioner's notes appears at pages 19–25 of the printed record. Specific pertinent provisions may be mentioned as follows:

Their central and dominant feature was an unqualified promise to pay to each payee a fixed sum of dollars at a definite maturity, slightly over twenty-five (25) years after the date of issue (R. 19, 74, 95). The Petitioner further promised to pay interest upon such fixed amount of principal at not less than 2% nor more than 10% in each year and, within that range, at the rate (to the nearest 1/4%) which a sum equal to two-thirds (2/3) of the Petitioner's net earnings for the fiscal year would represent upon an assumed principal of $400,000 (R. 20, 75, 95).

Interest for the year ended September 30, 1940, was determined at the rate of 10 per cent in accordance with these provisions (R. 48, 78, 96–97) being the $40,000 the deduction whereof is in question (R. 78, 93).

The notes further provided for the payment of interest under certain circumstances at the flat rate of 6% (R. 20, 21, 22); the power of the Petitioner to defer payment of interest, only as its Directors in good faith should determine to be necessary, and in no event beyond December 1, 1964 (R. 20); acceleration of maturity in event of bankruptcy and the like (R. 21); the power of the Petitioner to effect subordinations to other obligations maturing not later than December 1, 1964 — there was no general subordination, only a power to make, and under proper conditions terminate, subordinations — (R. 21–22); the power to call and retire the notes (R. 22–23); the power of three-fifths (3/5) of the noteholders to consent to changes, not affecting the fundamental obligations (R. 23–24); and certain provisions affecting transferability (R. 24).

The recapitalization, in the course of which the notes were issued, is set out in the record (R. 10–13; 18–19; 26–28; 36–39; 41–45).

Certain specific subordinations, since terminated, are set out in the record (R. 14; 29–35; 44–45; 46–47).

Nowhere in the Commissioner's pleadings or in the findings of the Tax Court or in the opinion of the Circuit Court of Appeals can be found any suggestion that the promises embodied in the Petitioner's notes were not genuine, or not made in good faith, or not intended to be performed in accordance with their terms. There was no suggestion that the notes were a "sham," or that they did not embody the real understanding of the parties to the transaction.[1]

Nevertheless, the Tax Court held that the notes did not create any "proper indebtedness," that they "were more in the nature of a capital investment than a loan to the corporation," and that the payments made as interest were not deductible under Section 23 (b) of the Internal Revenue Code (R. 81).

The Tax Court based its conclusion upon the circumstances:—(a) that the notes bore a "variable rate of interest computed with reference to profits" (R. 79); (b) that they were "issued in exchange for stock of the issuing corporation" (R. 79, 80); (c) that the notes provided under certain circumstances that "the payment of interest might be deferred" (R. 79); and (d) that the "factor of tax avoidance" was a "substantial purpose motivating the transaction" (R. 80). It asserted that the "cumulation of these various restrictive features . . . tends to cast doubt on the real nature of the instant transaction" (R. 80); that therefore the intent of the parties must be sought, with evidence *aliunde* the contract admissible (R. 80); and that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management,[2] but extending a tax advantage to the corporation not possible in stock" (R. 80–81).

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[1] See specifically the dissenting opinion (R. 103).

[2] Ignoring the obvious fact that this right was attached only to the remaining outstanding stock, not to the notes.

The Circuit Court of Appeals based its decision upon the circumstances that the notes were issued in exchange for stock (R. 98, 101); that the rate of interest was variable (R. 99–100); that the notes were capable of being subordinated to the claims of other creditors (R. 101); that the payment of interest could be deferred (R. 100); and that Petitioner had "tax avoidance" as a motive in the issuance of notes in exchange for stock (R. 98–99). It also held that the meaning of the notes was governed by extrinsic evidence (R. 98, 99). In addition, the Court relied upon *Dobson* v. *Commissioner*, 320 U. S. 489 (1943) as requiring that the Tax Court be upheld.

Both the Tax Court and the Circuit Court of Appeals also apparently regarded as material the facts that the Petitioner had but few stockholders, who were related by blood or marriage; that the noteholders also continued to hold stock; and that but few of the notes had been transferred to date (R. 74, 76, 80, 94, 98, 99).

The Tax Court and the Circuit Court of Appeals both ignored the strong categorical language of I.R.C. Section 23 (b) providing that deduction shall be allowed for "*all interest* paid or accrued within the taxable year on indebtedness" (italics added). Both paid as little regard as possible to the fundamental fact that the notes embodied a firm promise to pay a fixed sum of money at a fixed maturity, which, at least for every purpose other than taxation, would unquestionably constitute an indebtedness. Both concerned themselves with "tax motives." The error of both decisions is made sharply clear by the contrast presented by the dissenting opinion of Judge Magruder (R. 101).

SPECIFICATION OF ERRORS

The Petitioner specifies the following errors committed by the Circuit Court of Appeals.

1. The Court erred in holding that the sums accrued as interest upon the Petitioner's outstanding registered notes were not deductible as interest under Internal Revenue Code, Section 23 (b).

2. The Court erred in applying a rule which makes only some interest upon some indebtedness deductible, whereas the statute grants a deduction to *all* interest upon indebtedness. Herein of "judicial legislation." *Crooks* v. *Harrelson*, 282 U.S. 55, 75 L. Ed. 156 (1930); *Iselin* v. *United States*, 270 U.S. 245, 70 L. Ed. 566 (1926).

3. The Court erred in failing to construe the term "interest" in said statute as including the amounts accrued upon the Petitioner's registered notes.

4. The Court erred in failing to attribute to the terms "interest" and "indebtedness" in said statute their plain and natural meaning as reflected in common usage and general law. *Deputy* v. *DuPont*, 308 U.S. 488, 84 L. Ed. 416 (1940).

5. The Court erred in failing to construe the term "indebtedness" in the statute as including the principal obligation created by the Petitioner's registered notes.

6. The Court erred in construing the statute by the application of an untenable distinction between "loans" and "capital investments."

7. The Court erred in using extrinsic evidence to control the meaning of Petitioner's notes. *Hamilton* v. *Liverpool, etc. Ins. Co.*, 136 U.S. 242, 34 L. Ed. 419 (1890).

8. The Court erred in applying criteria, applicable only in cases of alleged sham and the like, to a case in which there was in fact no question and no issue but that the Petitioner's notes were genuine and intended to be enforced according to their terms.

9. The Court erred in holding in effect that interest, to be deductible under the statute, must not be at a rate measured with reference to profits. *Meehan* v. *Valentine*, 145 U.S. 611, 36 L. Ed. 835, (1892).

10. The Court erred in regarding and making the basis of its decision such factors as:

(a) That the Petitioner's notes were issued in exchange for stock;

(b) That the Petitioner's notes provided for a variable rate of interest;

(c) That the Petitioner's notes brought no new capital into the corporation;

(d) That the Petitioner's notes were capable of being subordinated to claims of other creditors;

(e) That under the provisions of Petitioner's notes payments of interest might be deferred;

(f) That Petitioner's notes were held by persons who were also stockholders;

(g) That the holders of Petitioner's notes were related by blood or marriage.

11. The Court erred in regarding and making the basis of its decision, the circumstance that a tax advantage was a principal purpose of the recapitalization in which Petitioner's notes were issued. *Bullen* v. *Wisconsin*, 240 U.S. 625, 60 L. Ed. 830 (1916).

12. The Court erred in treating the indebtedness actually created by the Petitioner's notes as if it were "form" instead of "substance" in a case in which there was neither evidence nor suggestion of sham or unreality, or of a temporary expedient (Cf. *Gregory* v. *Helvering*, 293 U.S. 465), or of a transaction for security only or to achieve some other unrelated end (Cf. *Wiggin Terminals* v. *United States*, 36 F. 2d 893; *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833).

13. The Court erred in failing to apply the rule of construing tax statutes in favor of the taxpayer, *Gould* v. *Gould*, 245 U.S. 151, 62 L. Ed. 211 (1917), in a case where the application of such rule merely required giving to the language of the statute its plain, straightforward meaning.

14. The Court erred in applying the rule of *Dobson* v. *Commissioner*, 320 U.S. 489, in a case in which the fundamental issues involved were issues of law and not of fact.

STATUTE INVOLVED

The statute under which the deduction is claimed is as follows:

INTERNAL REVENUE CODE

Sec. 23. Deductions From Gross Income

In computing net income there shall be allowed as deductions:

(b) *Interest.* — All interest paid or accrued within the taxable year on indebtedness, except . . ." (Exception not material)

SUMMARY OF ARGUMENT

The statute is absolute and general in allowing *all* interest upon indebtedness to be deducted with but a single (not here relevant) exception. It has been so for twenty-seven years. No regulation has even attempted to engraft exceptions upon it. Its terms are to be given their common and ordinary meaning. The plain and straight forward generality of the statute should be adhered to, as against the reading in of exceptions which have no textual support. At least to this limited degree, any "doubts" should be "resolved in the taxpayer's favor."

"Indebtedness" simply means the owing of money. "Interest" simply means the agreed (or otherwise lawfully determined) compensation for the delay in paying off the debt. The debt is the basic thing. Interest is the incident of debt. Given a debt, interest may take any lawful form.

By these criteria, the taxpayer's notes are to be judged. Their character does not turn upon whether their holders are

kin by blood or marriage or are also stockholders in the debtor corporation. It is not altered by their containing lawful agreements as to the manner in which the holders will enforce or refrain from enforcing the debts. It is not dependent upon an alleged distinction between "investments" and "loans," nowhere suggested by the text of the statute.

These notes stand in their own right. Their sole purpose is to evidence the indebtedness which they embody. There is no evidence that they were merely instrumentalities to accomplish some different ends. There is no evidence that they were unreal — a "sham" — with the realities governed by some other inconsistent arrangement. There is no evidence that they were a temporary expedient, not meant to last and govern according to their terms. There is not even such a claim advanced. Hence they are to be judged by their actual character as disclosed upon the face of an unambiguous document.

So, judged, they are debts and can be nothing but debts. They promise to pay a fixed sum at a fixed maturity, and meanwhile to pay interest thereon. Interest is at a sliding scale, having reference to earnings, but it is none the less interest, i.e., compensation for the detention of the principal. Year by year the rate becomes fixed and the obligation becomes absolute; payment must eventually be made. Our agreement merely allows the owners of the corporate equity to get something whenever the earnings are more than sufficient to pay the 2% minimum on the notes. In exchange for this consideration, the noteholders are allowed a possible, correspondingly high, maximum rate of 10%.

The Courts below have utterly confused "motive" and "intent." The result — and the manifest purpose — is to deny the deduction because one *motive* of the recapitalization was to give the petitioner a more favorable tax position. This result, which could not properly be reached by direction, is equally improper when reached by indirection. The Courts below

first treat an obviously unambiguous instrument as if it were ambiguous and then resolve the alleged ambiguity by talk about "intent" which upon analysis is nothing but "motive." The Tax Court is so far away from the statute that it never even quotes the statute in its opinion. The Circuit Court of Appeals mentions the statute but makes not the faintest effort to deal with its categorical language.

Citizens have a right to arrange their affairs with a view to the minimum incidence of taxation, so long as they do it openly and squarely, without sham or the adoption of meaningless temporary expedients. It is the duty of the courts to refrain from "judicial legislation" and to regard the direct, clear language of the statute. And the *Dobson* decision is not a formula for altering the law under the guise of a "finding of fact."

The Petitioner protests against a judicial technique which disregards the express language of the statute, treats a genuine business arrangement as if it were a sham although no issue of sham exists, disregards applicable rules for the construction of statutes, in effect asserts the existence of a common law of taxation with a right to control and alter the statutes enacted by Congress, discriminates against the Petitioner because it is owned by a few people instead of by many, and in general deprives it and all others similarly situated of their clear rights under the law. The issue is not whether it is wise legislation to allow the deduction of this particular interest. Congress has allowed the deduction of *all* interest. If this is unwise the remedy lies with Congress. The deduction should be allowed.

ARGUMENT

I. All Interest is Deductible Under the Statute, not Just Some Interest or Interest on Just Some Types of Indebtedness.

The Statute, I.R.C. § 23 provides

"In computing net income there shall be allowed as deductions: . . .

(b) INTEREST. — *All interest paid or accrued within the taxable year on indebtedness*, . . ."

We call attention to the word "all," and ask . . . does it mean all or does it not? In the statute itself, there is found a single express exception, not here relevant.[2] There once were elaborate limitations upon the deduction of interest by corporations (Revenue Act, 1916, § 12 (a) Third) but these were all swept away in 1918, when corporations were given the same broad deduction for interest which individuals had already enjoyed.[3]

From 1918 forth, Section 23 (b) has stood unchanged, so far as concerns our case.[4] For twenty-five years its form has been as nearly categorical and all-inclusive as could well be conceived. The words are "all interest . . . on indebtedness." Congress could hardly have made the language stronger —

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[2] The statute continues: — "except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this Chapter."

[3] See Appendix C., p. 54 of this brief, where the liberalization of the deduction afforded by the Revenue Act of 1918 is set forth.

[4] Rev. Act 1934 § 23 (b) is identical, and all changes in prior acts since 1918 have affected only the exception relating to money borrowed to purchase or carry non-taxable securities or like property. Rev. Acts: 1932, § 23 (b); 1928 § 23 (b); 1926 § 214 (a) (2), § 234 (a) (2); 1924, § 214 (a) (2), § 234 (a) (2); 1921, § 214 (a) (2), §234 (a) (2); 1918, §214 (a) (2), § 234 (a) (2).

unless, indeed, it is to be held the duty of the legislative, when trying to attain inclusiveness, to clutter up statutes with such expressions as "of all kinds, manners and descriptions whatsoever."

The presence of a single (not here relevant) exception shows that Congress has adverted to the possibility of exceptions and has made but one; and the radical destruction in 1918 of the limitations upon corporate deductions of interest found in the 1916 Act, demonstrates an affirmative purpose that the deduction be sweeping and general.

In his published Regulations, the Commissioner has provided, in part and so far as possibly relevant

> "INTEREST. —*Interest paid or accrued within the year on indebtedness may be deducted from gross income* . . . . .
>
> *"Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income."* Regulations 101, Art. 23 (b) —1.

The regulation was the same when our notes were issued, and in all relevant respects stands unchanged today (Regulation 111, Sec. 29.23 (b)–1). It contains no intimation of any official administrative purpose to engraft exceptions or limitations upon the general and categorical deduction granted by the statute.

By implication (from the negative proposition asserted at the beginning of the last quoted paragraph) the Commissioner recognizes that even interest on "capital or surplus invested in the business" is an allowable deduction whenever it is "a

charge arising under an interest-bearing obligation." This is highly incompatible with the Tax Court's notion that an interest-bearing obligation is not indebtedness when it is "more in the nature of a capital investment than a loan." T.C. Opinion, (R. 81)

The regulation provides that "so-called interest *on preferred stock*, which is really a dividend thereon" is not a deduction, a conclusion with which no one will disagree, but the regulation nowhere attempts to say that some types of indebtedness shall be treated as if they were preferred stock for the purposes of the deduction, which is what he is now asserting without foundation in either statute or regulation.[5]

2. THE WORDS "INDEBTEDNESS" AND "INTEREST" WERE USED IN THE STATUTE IN THEIR COMMON AND ORDINARY MEANING, AS WELL ESTABLISHED IN GENERAL LAW. PETITIONER'S NOTES EVIDENCED SUCH INDEBTEDNESS AND PROVIDED FOR SUCH INTEREST.

In *Deputy* v. *Dupont*, 308 U.S. 488, 493, 84 L.Ed. 416, 421 (1940), this Court said,[6]

> "And when it comes to construction of the statutory provision under which the deduction is sought, the

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[5] From what regulation would the taxpayer even have drawn warning of the Commissioner's present claim that interest on indebtedness is not deductible because, for example, the creditors also hold stock, or are few in number, or are related by blood or marriage, or have stipulated for a sliding scale of interest, or have agreed in certain events to postpone their claims, or have been or done any or all of the many things that creditors may lawfully be or do?

[6] Accord, *Equitable Life etc. Society* v. *Commissioner*, 321 U.S. 560, 88 L. Ed. 927 (1944); *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 560, 76 L. Ed. 484, 489 (1932); *Noteman* v. *Welch*, 108 F. 2d 206, 213 (C.C.A. 1st 1939). Thus "indebtedness" or "interest" cannot be stretched to cover the

> general rule that 'popular or received import of words furnishes the general rule for the interpretation of public laws,' . . . is applicable."

Thereupon, as an illustration of this principle, the Court offered the following definition of interest.

> "In the business world, 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Id. 498; L. Ed. p. 424.

These carefully selected words "compensation for the use or forbearance of money" definitely exclude from consideration the question whether the debt was incurred as the purchase price of the debtor's own stock. Obviously there is "forbearance of money" so long as the creditor, voluntarily or in accordance with his written contract, forbears to receive from the debtor the sum owed. And a sum may become owing for any valuable consideration. Manifestly the surrender of the Petitioner's stock in the present case was such a valuable consideration.[7]

Indebtedness and interest are essentially legal concepts, about the broad outlines of which there are no substantial disagreements. Legal and general lexicographers accord

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obligation incurred by borrowing on shares of stock against short sale (the *DuPont* case) or to include "excess interest dividends" on insurance policies paid wholly at the company's discretion (the *Equitable Life* case) or be narrowed to an accountant's concept of "effective rate" of interest (the *Old Colony R.* case) or so as to exclude a portion of a stipulated rate as being "for expenses" (the *Noteman* case). But neither, we submit, may these terms be narrowed by construction in a way which amounts to the creating of exceptions.

[7] See dissenting opinion of Magruder, J. (R. 102)

them much the same meanings,[8] although the general definitions may in some respects be too broad in including types of "obligations" which the law would not call debts.[9]

Persons think of a "loan" as a first class illustration of a situation in which interest is paid, but "the man in the street" also realizes that many debts arise without money changing hands, as for example, a purchase money mortgage on a house or a note given for a grocer's bill. No one would question that one may go in debt for the price of a horse or for the price of corporate shares, or that, if the corporation itself buys the shares, it is just as much bound to pay the stipulated price and its long term promise to do so is a debt. The Tax Court erred in making "loan" the crucial word. T.C. Opinion (R. 80, 81).

"Debt" and "interest" have never turned upon whether several creditors were kindred to each other or were also stockholders in the promisor corporation or had entered into lawful agreements about the manner in which they would enforce or refrain from enforcing their debts or had stipulated to take less than a maximum rate of interest in certain circumstances.[10] A suggestion that such considerations should be engrafted, by way of qualification or exception upon the definitions quoted above, would not accord with common understanding (and yet is the essence of the Tax Court's decision).

"Debt" and "interest" have nothing to do with a shady distinction between "investments" and "loans." In common speech the term "investment" covers both the common stock and the mortgage bond. Yet the government argued for, and the Tax Court seems to have drawn, some such distinction.

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[8] See illustrative definitions in Appendix D, p. 57, infra.

[9] Cf. *Deputy* v. *DuPont*, supra, p. 497.

[10] See discussion of the "sliding scale" of interest at pages 19–22, infra.

See T. C. Opinion (R. 81). In the broad and true sense, a purchase money note represents a loan. In a narrow sense it may not. All such issues were avoided by Congress' selection of the generic term "indebtedness."

The Circuit Courts of Appeal have correctly held that

> "The essential feature of the debtor-creditor relation is the presence of a fixed maturity date at which time the holder can demand payment, whether or not there are net earnings."
>
> *Commissioner* v. *H. P. Hood & Sons Inc.*, 141 F. 2d 497 (C.C.A. 1st, 1944)
>
> *Haffenreffer Brewing Co.* v. *Commissioner*, 116 F. 2d 465, 468 (C.C.A. 1st, 1940)
>
> *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11, (C.C.A. 2nd, 1935)
>
> *Commissioner* v. *National Grange Mutual Liability Co.* 80 F. 2d 316 (C.C.A. 1st, 1935)

Manifestly, this "fixed maturity date" means a date for the payment of *principal*, for the principal obligation is the one basic element of an indebtedness. Interest is only an incident, which may not even exist, but its existence is absolutely dependent upon there being a debt.

So the first question, and it is an easy one, is: Was Talbot Mills in debt to its noteholders? To give the answer it should be sufficient to point out that the notes are outstanding in a fixed aggregate sum (R. 12, 19, 74, 94); that in each individual note, a definite number of dollars was obviously to be filled in (R. 18, 19, 74, 94); that Petitioner promised unqualifiedly to pay this sum on December 1, 1964 (R. 19); that this maturity might be accelerated in certain circumstances (having nothing to do with "earnings") (R. 21, 22) but might not be postponed (R. 22 — "no such change shall . . . . extend the date for the maturity of the principal of the notes.")

The fixed maturity was buttressed by provisions forbidding any subordination agreement, or mortgage of corporate property, to run beyond December 1, 1964 (R. 21). There was no general subordination, but only a power to make and terminate subordinations, and at the date of trial the notes stood free of subordination (R. 21–22, 14, 78, 32). It may be of some significance that the name of the instrument is "registered note" and that the references throughout are to "this note" or "these notes," and to "interest." (R. 19, 21, 22, etc.)

Manifestly the liability to pay principal ran against all the corporate funds, and was utterly independent of earnings. The notes were fully transferable, the requirement or registration being merely to protect the corporation in dealing from time to time with whoever may be the recorded owner. They were to be outstanding for 25 years and at the end of that time would represent for the corporation a fundamental problem of payment or refunding. They cannot be two different kinds of securities at once,—stock in the hands of a Talbot descendant; debts in the hands of a stranger.

We therefore confidently submit these notes to the test: what would a purchaser of one of these securities justly and properly conceive that he had acquired, the position of a creditor or the position of a proprietor? There is no better test to be used when considering the application of statutory words which are to be given their "usual, ordinary and everyday meaning."

We submit that such a purchaser would consider himself a creditor and would be justly amazed and aggrieved if told that he was not. For a single example, let us assume a bankruptcy. Can it be doubted that he would have a provable claim, even if the notes were still subordinated (which they now are not).

At the other extreme, what proprietary right could he conceivably exercise? Could he bring a stockholder's bill to

attack mismanagement, or would he be entitled to complain only of such matters as are "in fraud of creditors"?

When interest is due, he is entitled to be paid (subject to any subordination) unless payment has been deferred "in good faith" by reason of need. Can there be any doubt but that he could, in the courts, challenge bad faith? And would he, in so doing, be acting in any other right than as creditor?

At maturity, at his own mere demand, he may have the principal (and any accrued and deferred interest) if the corporation has any property with which to meet its debt. He has made no indefinite commitment of his funds to the enterprise. He has acquired the right to an annual reward for their use, varying somewhat with the debtor's degree of success. This reward is interest, or the law knows no true name for it.

It is difficult to argue the obvious, but we have tried to spell it out. It is clear that in common parlance as well as general law the Petitioner's notes, with their central unqualified obligation to pay a fixed sum at a fixed maturity, were the written evidences of an indebtedness. And, if they were, it necessarily follows that the amount paid to service the debt was interest, however fragile, qualified or complicated the interest terms might be. Interest is no necessary feature of an indebtedness. There are debts which do not bear interest. And, if that is so, then, given a debt, it follows that any not unlawful stipulation with respect to the compensation to be paid for forbearance of the debt is interest. It is impossible to arrive at the result reached by the Tax Court and the Circuit Court of Appeals without coming in conflict with *Deputy* v. *Dupont*, *supra*.

And we would call attention to the balance of the quotation from that decision.[11]

"In sum, we cannot sacrifice the 'plain, obvious and

[11] Following the words quoted at p. 14, supra

rational meaning' of the statute even for the 'exigency of a hard case'."

There is no right, either, to sacrifice the plain, obvious and rational meaning, and create exceptions where none are to be found, merely because the Commissioner, or even the Court, thinks that Congress would be well advised to legislate an exception or qualify the absolute words it has chosen to use.

3. INTEREST IS STILL INTEREST, NOTWITHSTANDING IT BE A SLIDING SCALE, OR BE OTHERWISE QUALIFIED, SO LONG AS IT IS THE COMPENSATION FOR THE FORBEARANCE OF A DEBT.

In *Meehan* v. *Valentine*, 145 U.S. 611, 36 L. Ed. 835, this Court said, as follows:

> "In whatever form the rule is expressed, it is universally held that an agent or servant, whose compensation is measured by certain proportion of the profits of the partnership business, is not thereby made a partner, in any sense. So an agreement that the lessor of a hotel shall receive a certain portion of the profits thereof by way of rent does not make him a partner with the lessee. . . . And it is now equally well settled that the receiving of part of the profits of a commercial partnership, in lieu of or in addition to interest, by way of compensation for a loan of money, has of itself no greater effect." 145 U.S. p. 624; 36 L. Ed. p. 841.

It seems perfectly clear that it is a legitimate, and may be a wise, arrangement for a creditor to make with a debtor that the rate of pay which he is to receive for his forbearance of money be related to the success of the debtor during the term of forbearance. And if such an arrangement with a partnership, which is not a legal entity, does not make a creditor a partner, *a fortiori* such an arrangement with a corporation, which is a legal entity, can hardly of its own

force render the creditor a stockholder.[12] Even the Tax Court itself, at the government's own instance, has held that interest may properly be measured in relationship to the debtor's earnings. See *Kena, Inc.*, 44 B.T.A. 217[13]

In other fields, it is perhaps commonly known that royalties on patents and the like are frequently measured with reference to earnings; that during the "depression" the rentals of real estate were sometimes contracted for with reference to the tenant's gross or net receipts; and that compensation contracts may refer to earnings.[14] See, as an instance of the latter sort, *Austin v. United States*, 28 F. 2d 677 (C.C.A. 5th, 1928).

In the case of Petitioner's notes, part of the interest is in no respect referable to earnings. The minimum rate of 2% is absolutely payable without recourse to any computation. But even in the use of the formula, it is always a rate % (to the even ¼%) that is to be ascertained. Never do the noteholders receive a portion of the earnings as such.

Thus, the minimum and maximum extend equally in the two directions from a mesne rate of interest of 6%, and 6% is the rate provided for in all instances in which the computation based on earnings is inapplicable, namely, for the period running to maturity from the end of the previous fiscal year (R. 20) for the period running to the date of accelerated maturity from the end of the previous fiscal year

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[12] See dissenting opinion of Magruder, J. (R. 101–2, 104)

[13] If the Tax Court possesses some peculiar power of divination in tax cases (under an erroneous extension of the *Dobson* case), which time did it divine correctly, in the *Kena* case or in the present case which does not purport to overrule the *Kena* case!

[14] In compensation cases the statute imposes a requirement of "reasonableness," I.R.C. Sec. 23 (a) (1) (A) but the deduction for interest is unqualified.

(R. 21), and for the period running to a date of voluntary retirement from the end of the previous fiscal year (R. 22). But, as said above, it is always a rate % that is to be ascertained!

We have pointed out that a debt is not dependent upon the existence of an interest obligation, hence it is not wholly appropriate to test the existence of a debt by scrutiny of the interest provisions. Nevertheless it may be in order to mention certain other features of the notes, relating to interest.

There is a power in the corporation, acting "in good faith . . . by reason of the condition of the corporation," to defer the time of payments of interest, but this may not extend beyond the date of maturity. (R. 20) This is clearly a legitimate agreement, and has been held not to alter the quality of an obligation.

Commissioner v. *H. P. Hood & Sons, Inc.* 141 F. 2d 467 (C.C.A. 1st 1944)

Commissioner v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C.C.A. 2nd, 1935)

The "interest," like the principal may be subordinated, but this may not run beyond the date of maturity. (R. 21) Subject only to such subordination, the right to the interest runs against all the corporate funds, and no dividends may be paid unless the interest is paid in full. (R. 20) Agreements of subordination are in common commercial usage. Even an absolute general subordination to claims of all other creditors, has been held not to turn a debt into stock.

Commissioner v. *O. P. P. Holding Corp., supra*

It follows from all the above, that it was not proper for the Courts below to rest their decisions upon the feature of the variable rate of interest. Nor would it be according due regard to the decisions of this Court to say that this feature, in combination with other features, every one of which are

common permissible arrangements in connection with an indebtedness, turns a creditor into a stockholder when each feature by itself has no lawful tendency to do so.

4. THE COURTS BELOW HAD NO RIGHT TO REGARD "EVIDENCE ALIUNDE THE CONTRACT" OR APPLY FACTUAL TESTS APPLICABLE ONLY IN CASES OF "SHAM" AND THE LIKE.

In *Hamilton* v. *Liverpool, etc. Ins. Co.*, 136 U.S. 242, 34 L. Ed. 419 (1890), this Court said that construction of the correspondence in writing between the parties presented a pure question of law to be decided by the Court.[15] In the present case, there is a complete and integrated document of the sort with respect to which loose ends are never intentionally left and which, by virtue of intended transferability, is the least subject to be controlled by extrinsic evidence.

The Court below, in the course of reaching a particular tax result, has talked about "consideration of the relevant facts," (R. 97), about looking to "actualities of the situation," (R. 98), about looking to see whether interest may be regarded as the "further distribution of profits" (R. 97), and about "exalting form above substance." (R. 98) The Tax Court talked about "intent," (R. 80–81), and obviously meant "motive." All these expressions have merely served to conceal the actual issues.

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[15] Accord: *Commissioner* v. *Coastwise Transportation Corp.*, 71 F. 2d 104, 105 (C.C.A. 1st, 1934); *Brown* v. *J. C. Shaffer Grain Co.*, 15 F. 2d 514 (C.C.A. 1st 1926); *S. S. Kresge Co.* v. *Sears*, 87 F. 2d 135, 138, 140 (C.C.A. 1st, 1936); *Union State Bank & Tr. Co.* v. *Northwestern Life Ins. Co.*, 55 F. 2d 1070, 1072 (C.C.A. 5th, 1932); *S. H. Kress Co.* v. *Fisher*, 65 F. 2d 682, 683 (C.C.A. 4th, 1933); *Merinos Viesca Y Compania* v. *Pan American P & T Co.*, 83 F. 2d 240, 242 (C.C.A. 2nd, 1936); *National Surety Corp.* v. *Ellison*, 88 F. 2d 399, 403 (C.C.A. 8th, 1937)

In a given case, two main questions could arise:

(a) Is the instrument genuine, and not a sham; is it the agreement itself or merely a technique to support a different arrangement; is it durable or is it only evanescent?

(b) If the instrument is genuine, represents the agreement itself and has a durable existence, then what do its terms mean?

Actually only the second question arises in this case. Yet the Courts below have decided it as if the first were involved.

That the distinction may be clear, we offer several examples of how the first question might have arisen.

(a) The case of "sham": Had the Commissioner contended that the notes were only an appearance, actually vitiated by a secret agreement not to regard them, the scope of permissible evidence would have been wide. Actually the Commissioner made no such contention, the Tax Court made no such finding and the evidence would be incapable of supporting such a finding, if made.

(b) The case of a technique to support a different arrangement: Illustrations are (1) *Wiggin Terminals, Inc.* v. *United States*, 36 F. 2d 893 (C.C.A. 1st, 1929), where the security issued was unquestionably preferred stock, but it was issued to certain persons to hold only until through the medium of dividends they had received a 100% bonus upon a certain loan and then was to come back to the Company. The money paid as dividends was held deductible as interest, because the stock and the dividends were nothing but an agreed vehicle for paying what had actually been stipulated for as interest. (2) *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.C.A. 7th, 1927) where stock was used as a device to conceal a usurious loan. In the present case there is no evidence, or purported finding, of the existence of a like situation.

(c) The case of a temporary expedient: The typical example is *Gregory* v. *Helvering*, 293 U.S. 465 (1935). There, direct action would have resulted in a taxable gain. Therefore unnecessary indirect action was taken, and a structure raised like a scaffolding, to be torn down the instant the tax result was obtained.[15a] The present case presents nothing of the sort.

There is a fundamental distinction between (a) a transaction having no reality of its own, but erected as a form to meet superficially some language in the tax statute, and then be dissolved (the *Gregory* case), and (b) a transaction which, though motivated in whole or in part by reasons of tax advantage, is a genuine, durable rearrangement of the business or financial relations of the parties (the present case). The latter transaction cannot rightfully be ignored.[16]

The second question, therefore, is the only one in this case: — what do the terms of the notes mean?

These instruments are not fairly to be described as "ambiguous." What they mean and what they are is essentially a question to be determined from the documents themselves, an issue customarily treated as one of "law" rather than of "fact."

These notes mean the same thing when they are issued by the Talbot Mills as they would if issued by the United States Steel Corporation or by a railroad in reorganization. They mean the same thing when held by a person who is also a stockholder as when held — as they all might come to be

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[15a] See *Helvering* v. *Alabama A. Limestone Co.*, 315 U.S. 179 (1942) pp. 184–5, "Transitory phases."

[16] Matters relating to corporate financing concern the very existence of a corporation. Cf. *Lydia E. Pinkham Medicine Co.* v. *Gove*, 303 Mass. 1, 12. (1939). And see discussion of *Gregory* v. *Helvering*, in *National Investor's Corporation* v. *Hoey*, 144 F. 2d 466, 468 (C.C.A. 2d, 1944).

— by a person who holds no stock at all. To say otherwise is to make a travesty of the law for the sake of the revenue.

The Courts below have wholly misused the language quoted by them from *Commissioner* v. *Proctor Shop, Inc.*, 82 F. 2d 792, 794, 30 B.T.A. 721, 725, with respect to use of "evidence aliunde the contract." That language was proper with respect to *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833, 834, and to the *Wiggin Terminals* type of case, as to which see p. 23 this brief *supra*, from which decision quotation was made in the *Proctor Shop* decision. But it was not proper in the present case.

One fundamental error of the Tax Court's opinion lies in its confusion of "intent" with "motive." Obviously, the petitioner's clear intent was to issue this specific security, just as it is, a security which has every essential feature of an indebtedness, and every feature of which has in one case or another been held to be a permissible feature of an indebtedness.

Whence then comes the "doubt" as to "the real nature of the instant transaction"? It comes from an illegitimate concern with matters of motive, and an invalid conception of the use which may be made of extrinsic considerations dealing with motive. This "doubt" does not render the notes ambiguous, nor does it authorize the consideration of "evidence aliunde the contract" (not really to "explain" but actually, as used by the Court) to contradict their terms.

It was therefore completely erroneous for the Tax Court and the Circuit Court of Appeals to hold themselves entitled to give weight to such facts as that the Petitioner was owned by a few stockholders (R. 74, 80, 94, 98), or that the stockholders were relatives (R. 74, 80, 94, 98), or that the noteholders acquired their notes through giving up stock (R. 79, 80, 98), or that the holders of the notes also continued to hold their remaining stock (R. 80, 98), or that a small amount rather than a large amount ever changed hands.

(R. 80, 96, 99), and upon the basis of such considerations arrive at the conclusion that for purposes of taxation the notes were not the evidences of indebtedness which for every other purpose in general law and ordinary business life they were.

If this principle is not firmly maintained the tax status of various types of instruments, howsoever unambiguous, will become legally unpredictable despite the clear language of the statute. Various earlier decisions of the Circuit and District Courts, and of the Tax Court or Board, are not thoroughly reconcilable; but hitherto, at least, no authority whatever could have been adduced for treating as stock a security which was directly and truly a promise to pay a fixed sum at maturity and meanwhile to pay sums computed annually, either fixed or ascertainable, as the compensation

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A group of cases in which securities called "stock" were held to represent indebtedness:

Commissioner v. *Proctor Shop*, 82 F. 2d 792 (C.C.A. 9th, 1936); *Helvering* v. *Richmond F. & P. R. Co.*, 90 F. 2d 971 (C.C.A. 4th, 1937); *Palmer, Stacy-Merrill, Inc.*, 39 BTA 636; Affmd. 111 F. 2d 809 (C.C.A. 9th, 1940); *Diamond Calk Horse Shoe Co.* v. *United States*, D.C.D. Minn. 7/20/40, CCH Par. 9641, Appeal Dismissed on Stipulation 116 F. 2d 284 (C.C.A. 8th, 1940)

may be compared with cases reaching the contrary result:

Haffenreffer Brewing Co. v. *Commissioner*, 146 F. 2d 465, 468 (C.C.A. 1st, 1940); *Brown-Rogers-Dixson Co.* v. *Commissioner*, 122 F. 2d 347 (C.C.A. 4th, 1941); *Pacific Southwest Realty Co.* v. *Commissioner*, 45 BTA 426, CCH Dec. 12, 127, affd. 128 F. 2d 845 (C.C.A. 9th, 1942); *Parisian Inc.* 46 BTA 1279, CCH Dec. 12, 439-B, affd. 131 F. 2d 394 (C.C.A. 5th, 1942); *Commr.* v. *Schmoll Fils Assoc.*, 110 F. 2d 611 (C.C.A. 2nd, 1940) ("debenture").

for postponing the principal payment. Now such a result is reached, with respect to a concededly genuine security, by treating it as if it were ambiguous and then contradicting its plain meaning. Extrinsic evidence may not lawfully be used to such an end.

5. THE PETITIONER HAD A RIGHT TO REARRANGE ITS AFFAIRS WITH FRANK REGARD TO MINIMIZING THE INCIDENCE OF TAXATION.

In *Bullen* v. *Wisconsin*, 240 U.S. 625, 60 L. Ed. 830 (1916), this Court said,

> "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law." 240 U.S. p. 630–631, 60 L. Ed. p. 835.

The concern of the Tax Court and of the Circuit Court of Appeals with the Petitioner's so-called "tax motives" was improper under the language quoted above and, in effect if not in form, was a flat denial of the Petitioner's right to deduct the interest on notes outstanding if such notes were issued with tax objectives in mind.

Counsel have relied upon the famous words of Mr. Justice Holmes for many years. Constantly they have advised clients that they might so rearrange their affairs as to present the least exposure to taxation under the laws, provided only that in so doing their arrangements were genuine and durable and not false fronts for other underlying arrangements at variance nor temporary devices like the scaffolding that surrounds a building (Cf. *Gregory* v. *Helvering*, 293 U.S. 465). The citizens of this Country are entitled to know from this

Court whether that principle still prevails in its former integrity.

It is manifest that if the circumstance of "tax motives" may be utilized by the courts in the manner in which it was utilized in the opinions below, the words of *Bullen v. Wisconsin* become simply a trap for the unwary.

We recognize what is said about the "policy, if not . . . the mere letter of the law." But the policy of a federal tax statute is to be found in the statute itself, possibly illuminated by its history, and not in the policy-making tendencies of judges. It is notable that in the decisions below there was not made even the faintest attempt to interpret the words of I.R.C. Section 23(b) in the light of context or of other portions of the statute or of previous enactments or of legislative history. Instead the words were ignored and the policy was summoned into existence out of the judicial imagination.

It seems impossible, reading the majority decision in the Circuit Court of Appeals and the Tax Court decision, to avoid the conclusion that these tribunals in effect legislated against the Petitioner because of the belief that the Petitioner had substituted notes for stock to obtain a tax benefit to it.[18] Yet the Petitioner was thoroughly entitled to seek this result, in reliance upon what was said by this Court in *Bullen v. Wisconsin* and it is common knowledge that everyone does it whenever feasible.

The Petitioner went about the matter openly, issued notes that were absolutely genuine and vitiated by no secret underlying arrangement, incurred the heavy responsibility of facing a problem of refinancing at maturity and incurred a fixed obligation to pay at least 2 per cent interest in any event and an equally absolute obligation to pay as much

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[18] See, for a like technique, *Commissioner v. John Kelley Company*, 146 F. 2d 466, 468, (C.C.A. 7th, 1944) towards the end of the page.

more as might be determined by application of the interest formula. No issue of sham, temporary device or the like was or could have been presented.

It is natural and unavoidable that under pressures of taxation, people will seek to arrange their affairs to keep its incidence upon them at a minimum. Indeed, the complexity of tax laws, and the variety of circumstances under which they now impinge upon every move a man can make with respect to property have actually resulted in altering the standards of good judgment necessary to be applied to business arrangements or dispositions to be made with respect to property.

No one concerned with corporate finance or with the settlement of the affairs of an individual can today regard desired economic objectives in a tax vacuum. It is necessary to consider all objectives in the light of what may be done without incurring tax consequences so heavy as to prohibit the pursuit of those objectives. If, upon top of this, one is denied the right to rely upon the plain, clear language of the statute, and may expect what one does to be distorted by findings based on motives, the handicap becomes indeed grievous.

It is utterly unrealistic and unreasoning to assume that people will embark upon transactions wearing blinders, like a horse, to keep them from seeing the tax problems which lie on both sides of the road. The fundamental purpose of every business enterprise is to make money *and to keep it after it is made*, not just to make it in the spirit of a game, with indifference to its ultimate disposition. The choice between operating as a partnership or as a corporation necessarily involves a factor of "tax motives." So do innumerable other decisions. This case cannot be decided against the Petitioner without imperiling decisions made in every such field.

If we approach the present case with the utmost candor it all comes back to this: That the petitioner has deliberately, and for full consideration, incurred an indebtedness with

terms which (a) impose a *current* burden reasonably adaptable to varying ability to pay dependent upon results of the business, and (b) do not unreasonably impair its *current* credit position with banks and others. The Commissioner complains, and has persuaded the Tax Court, that it should not be able to do this since a "tax motive" existed.[19] But this is not the law and it has nothing to do with the question of what is interest. The taxpayer is entitled to a lawful judgment, regardless of its "motives."

Bullen v. *Wisconsin, supra*

6. THE DECISIONS BELOW ARE PURE "JUDICIAL LEGISLATION," NEITHER PERMISSIBLE NOR EVEN WISE.

Courts have had frequent occasion to admonish themselves against indulging in judicial legislation, even in the face of strong temptation. Such admonitions are frequently lively and pungent — bearing an implied tribute to the strength of the temptation. Thus

> "We should of course be faithful to the meaning of a statute. *But after all Congress expresses its meaning by words.* If legislative policy is couched in vague language, easily susceptible of one meaning as well as another in the common speech of men, we should not stifle a policy by a pedantic or grudging process of construction. To let general words draw nourishment from their purpose is one thing. *To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite an-*

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[19] The curious thing about the Tax Court's position is that even the conclusion it draws from its erroneous use of the "tax motive" is wrong. The existence of the "motive" can actually only testify to the genuineness of the intent to create an indebtedness, *for only if an indebtedness were actually created could the tax motive, upon which the Tax Court places so much weight, succeed and the deduction be achieved.*

other. For we are here not dealing with the broad terms of the Constitution 'as a continuing instrument of government' but with part of a legislative code 'subject to continuous revision with the changing course of events.' *United States* v. *Classic*, 313 U.S. 299, 316, 85 L. Ed. 1368, 1378, 61 S Ct 1031." (Italics supplied)

Addison v. *Holly Hill Fruit Products*, 322 U.S. 607, 617, 88 L. Ed. 1488, 1496

"It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts."

Crooks v. *Harrelson*, 282 U.S. 55, 60 (1930), 75 L. Ed. 156, 175

"What the government asks is not a construction of a statute, but, in effect, an enlargement of it by the Court, so that what was omitted, presumably by inadvertence, may be included within its scope. To supply omissions transcends the judicial function."

Iselin v. *United States*, 270 U.S. 245, 251 (1926) 70 L. Ed. 566, 69–70

See also,

Noteman v. *Welch*, 108 F. 2d 206, 208, 215 (C.C.A. 1st, 1939)

Mead Corporation v. *Commissioner*, 116 F. 2d 187, 191 (C.C.A. 3d, 1940)

Forstman v. *Rogers*, 128 F. 2d 126, 129 (C.C.A. 3d, 1942)

Western & Southern Life Ins. Co. v. Hunce, 116 F. 2d 1008, 1010 (C.C.A. 6th, 1941)

Decisions tainted with the vice of judicial legislation frequently have certain surface characteristics by which they tend to be recognized. In the present case, for example, legislation rather than decision is implicit in the course of the Tax Court in applying an undefined standard of "proper" interest and omitting all reference whatever to the statute itself. Again, when the petitioner's notes are gratuitously branded by the Tax Court as "voluminous and complex," when it is obvious that they are brevity and simplicity itself compared with the average major corporate security and underlying indenture, it is evident that the Court is building up a fighting approach to a predetermined conclusion.

By the use of its masterly ambiguity — "proper interest," the Tax Court in effect concedes that the sums in question were interest from some point of view, for otherwise the word "proper" would be meaningless. This word "proper" is the key word of the Tax Court's opinion, for in this one word the Tax Court has covered an unexpounded construction of a statute which it fails to quote.

Actually the statute is straightforward and all-inclusive. To say that under it some interest is "proper" interest and other interest is not "proper" interest, is either to say that the words "interest" and "indebtedness" as used in the statute were not used in their common and ordinary meaning or else to say that exceptions to the express grant of a deduction for "all" interest may be picked out of the thin air. On either alternative, what is involved is judicial legislation and nothing else, for neither position can find any support in the express words of the statute or even in implications legitimately drawn from the structure of the statute or the interplay of its provisions.

A construction of a statute which finds support neither in

the text of the particular provision nor in the structure of the statute as a whole is particularly suspect when it precipitates complicated and repetitive investigations of facts. "Had Congress intended to impose this heavy administrative burden of making such sweeping investigations into the factual backgrounds . . . it would have done so in clear and explicit language."[20] The present case affords an excellent example.

Obviously the Tax Court did not confine its inquiry to a comparison of the statute on the one hand and the terms of the notes on the other. It took into account motive, personal relationships, balance between noteholdings and stockholdings and the like. And it concluded that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock," hence creating no "proper" indebtedness.

Now whether "their voice in the management" was left intact was something that neither flowed, nor was in any wise capable of flowing, from the notes. It depended, on the contrary, on how much stock each noteholder held and whether he continued to retain it. Should either notes or stock be alienated or should even their proportions be varied, this characteristic which the Tax Court attributes to the notes, and which is really no characteristic of the notes at all, would disappear. Had the notes in their inception been issued to entirely different persons, the alleged characteristic could not have been claimed to exist at all. Similar comments could be made with respect to the fact of the personal relationships, the fact of "tax motive" and the like. They are transient and changeable conditions. Only the terms of the notes themselves are the fixed and certain element.

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[20] *Plimpton v. Commissioner of Internal Revenue*, 135 F. 2d 482, 486 (C.C.A. 1st, 1943), an admirable statement of the principle, in a First Circuit case not very dissimilar.

Thus a dilemma is presented. Either notes like these, no matter to whom or by whom issued or held, have always the same status in reference to the interest deduction, in which case the Tax Court has reached its conclusion by improperly concerning itself with irrelevant matters. Or else notes identical with these may or may not in each instance bear deductible interest; dependent upon a collateral inquiry which may range as wide as the great variety of facts which may bear upon the situation of the issuing corporation, the situation of the recipients of the security, the interplay and balance of motives and the like. And the investigation of such matters would be recurrent because the several factors involved are capable of changing from time to time. Had Congress intended to direct such investigations, for the purpose of resolving such distinctions, it would have used some language quite different from "all interest upon indebtedness."

Furthermore, if a rule is enunciated that only some sorts of interest are deductible, or that "interest" and "indebtedness" as used in the statute are to be given something other than their common and ordinary meaning, matters of substantially greater importance to the total economy than the problems of the Talbot Mills become clouded with doubt.

For example, it is common knowledge that in current railroad reorganizations, conducted under public supervision, large amounts of bonds are issued bearing interest so directly related to earnings as to be impossible to distinguish, in principle, from the interest provisions of the present notes. As an illustration, we have appended as Appendix B a condensed description of the terms relating to interest upon the recently-issued Erie Railroad Company General Mortgage Income 4½% Bonds, due January 1, 2015. These provisions, while not directly expressed in a sliding scale, actually have the same effect as a sliding scale, with a maximum rate, with an overall limit of 13½% on the cumulation of unearned

interest, with a provision for paying interest only in multiples of ¼% and with earnings adjusted for deficits of prior years in computing the currently payable rate. . . .

Every feature of the Talbot Mills Notes (laying aside for the moment the sliding scale of interest) is obviously a permissible feature of an indebtedness. To hold that the additional feature of a sliding scale of interest is the essential factor which turns what is otherwise clearly a note into "stock" for tax purposes, could hardly fail to cast doubt upon the deductibility of interest upon issues such as the bonds above described. And yet it is safe to assume that if the interest upon the Erie Income Bonds is not deductible, the consequence upon the revenues available for the Erie stock would obliterate assumptions legitimately made in formulating the terms of the reorganization itself.

And if, on the other hand, the Erie interest is deductible and the Talbot Mills interest is not, then there is an intolerable discrimination between the two corporations, in effect permitting to one and denying to the other the right to have a certain kind of security and have it recognized for tax purposes.

Is there one law for corporations with 15 stockholders and another law for corporations with 15,000 stockholders? Is there one law for corporations whose security holders are related and another law for corporations whose security holders are unrelated? Is there one law for the Erie Railroad and another law for the Talbot Mills?

Finally, we come to the uncertainties in the application of other provisions of the Internal Revenue Code created by the Tax Court's failure to apply to the petitioner's notes a proper interpretation of Section 23 (b) relating to the deductibility of interest. A complete development of this inquiry would require the quotation and analysis of separate statutory provisions more numerous than the compass of this brief would readily admit. However, the essential nature of the problem

is doubtless capable of being indicated with reasonable brevity.

In the structure of the Code certain terms bear certain relationships to each other, whether of affiliation or of contrast. Thus the term "interest" is tied up with "evidences of indebtedness" and "indebtedness," which latter term is doubtless equivalent to the term "debt" as variously used in the statute. In contrast with "evidences of indebtedness" appears frequently the expression "shares of stock," with which latter term the expressions "stockholder," "class of stock" and "dividend" are associated. Therefore, any denial that the petitioner's notes are evidences of indebtedness or that the annual sums accrued thereon are interest precipitates a further issue whether these instruments are shares of stock and the annual sums accrued thereon dividends.

Now the expressions "shares of stock," "stockholders" and "dividends" are properly to be given their "usual, ordinary and everyday meaning,"[21] this principle of statutory construction being by no means limited to its application to any one particular section of the Code. And it is impossible truthfully to call these instruments "shares of stock" within the usual import of that expression.

To illustrate the difficulties to be encountered and the number of different occasions upon which, or issues with respect to which, a false and artificial character would have to be attributed to these instruments in order to apply to them, in a manner consistent with the Tax Court's opinion, the various provisions of the Code, the following may be mentioned:

Consider, for example, whether, if they become worthless, they would be subject to the provisions of Section 23 (g) dealing with "capital losses" or Section 23 (k) dealing with

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[21] Quoted from *Deputy* v. *DuPont*, 308 U.S. 488, 498.

"bad debts." If they are not "evidences of indebtedness" within the meaning of Section 23 (k) (3); are they then "shares of stock in a corporation" within the meaning of Section 23 (g) (3)? And, if they are not the latter, under what section of the Code is the loss deductible and with what qualifications or limitations?

Under Section 23 (z), dealing with taxes and interest paid to co-operative apartment corporations, would a corporation which had only common stock outstanding, and which had financed in lieu of a mortgage by issuing notes like ours, be a corporation having "one and only one class of stock outstanding" within the meaning of Section 23 (z) (2) (A) (i); and would the holders of these notes, although actually not interested in occupying apartments in the building owned or leased by such corporations, nevertheless have to be counted for the purposes of Section 23 (z) (2) (A) (ii)?

Is there any reasonable basis for believing that a taxpayer could successfully claim that the annual sums accrued and paid upon these notes are "dividends" for the purpose of the "dividends paid credit" under Section 27, as forming part of the basic surtax credit under subsection (b) (1)? Or, if these notes had been issued prior to December 31, 1937, would not reasonable amounts, used or irrevocably set aside to pay or retire portions of the same, fairly be entitled to some consideration for the purposes of Section 27 (a) (4)?

Under the provision of Section 117 (i), if the losses of a bank from the sales or exchanges of any "evidence of indebtedness issued by any corporation * * * with interest coupons or in registered form" exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange is to be considered a sale or exchange of a capital asset. If a bank came to hold some of the petitioner's notes would the bank be denied the benefit of this section in connection with losses later realized upon the disposition of them?

Under Section 125 (d), the term "bond" includes any

"evidence of indebtedness, issued by any corporation and bearing interest * * * * with interest coupons or in registered form." Would a holder of these notes who might acquire them at a price in excess of par value be denied the privilege of amortization under Section 125? Some difficulty in settling upon a method of amortization might be presented by the sliding scale of interest, but it would equally be presented in the case of the Erie Railroad Bond referred to at p. 34, supra.

Under Sections 332 and 502, would the annual sums paid on these notes be "personal holding company income"? If they are not "interest," they could be includable only if held to be "dividends."

Consider also the problems to arise in connection with "equity invested capital" and the reduction of equity invested capital under Section 718 for the purposes of the excess profits tax. Also, the problem in connection with "borrowed invested capital" under Section 719; and consider how the expression "borrowed invested capital" is utterly incompatible with the Tax Court's notion of a criterion based upon a difference between "loans" and "investments."

A consistent result can be *forced* by saying that these notes are "shares of stock," that they represent "equity invested capital," that the annual sums accrued and paid thereon are "dividends" and the like. But the result cannot be reached by any fair interpretation of the terms just used and can be reached only by saying that, having decided that the notes are not evidences of indebtedness, they have to be stock, because that is all that is left. This would be merely balancing one error against another and pyramiding the consequences of the "judicial legislation" involved.

All these problems are to be avoided by simply attributing to the words "All interest . . . upon indebtedness" their plain and natural meaning, and giving to the Petitioner's notes themselves a proper judicial inspection to see if they embody a debt.

7. If There is Any Doubt About the Meaning of the Statute, it is the Kind of Doubt Which Should be Resolved in the Taxpayer's Favor.

In *Gould* v. *Gould*, 245 U.S. 151, 62 L. Ed. 211 (1917), this Court said,

> "In case of doubt" tax statutes "are construed most strongly against the government, and in favor of the citizen." 245 U.S. p. 153, 62 L. Ed. p. 213

This rule should have sufficient vitality at least to cause the courts to adhere to the plain generality of the text of a statutory deduction and refrain from engrafting upon it unwarranted exceptions. It is thoroughly capable of being reconciled with the rule of "strict construction" of exemptions, credits, deductions and the like, found in such cases as *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 76 L. Ed. 1128 (1932).

Careful examination of cases of the latter sort[22] will show that they have never expressly overruled the decisions for construction in the taxpayer's favor; that they have never used the "strict construction" rule to deprive a taxpayer of the benefit of the plain, fair, ordinary meaning of a provision establishing a deduction; and that the rule of strict construction has only been used to deny claims for the extension or expansion, by implication, of deduction sections, or to refute arguments which would have precluded the Court from exercising its proper judicial function in the resolving of genuine questions of construction.

We have materially expanded the argument, with citations, in Appendix A to this brief, to which attention is respectfully requested.

It takes little more than lip service to the principle enunciated in *Gould* v. *Gould* to reach the conclusion in the

[22] See cases abstracted in Appendix A, pp. 44–50, infra.

present case that a statute providing for the deduction of *all* interest on indebtedness may not by judicial construction be cut down into a deduction of some types of interest on some indebtedness. Unless and until the principle of *Gould* v. *Gould* is expressly overruled by this Court, the decision below stands in inescapable conflict with it:

8. THE DECISIONS BELOW ARE NOT SUSTAINABLE UPON THE BASIS OF DOBSON V. COMMISSIONER.

In *Dobson* v. *Commissioner*, 320 U.S. 489, 88 L. Ed. 248; rehearing denied, 321 U.S. 231, 88 L. Ed. 691 (1943) this Court said,

> "It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true, the Tax Court's decision would not be 'in accordance with law' and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts . . ." 320 U.S. p. 492, 88 L. Ed. p. 251.

The case related to whether certain transactions in separate years, relating to the same subject matter, should be treated for tax accounting purposes as a single transaction or as a series of separate transactions. This Court held that that Tax Court's determination of this issue should stand because the issue presented essentially a question of fact. The decision accords new emphasis to the finality to which decisions of questions of fact by the Tax Court are entitled when supported by substantial evidence. But, as the above quotation shows, it does not impart immunity to errors of law committed by the Tax Court.

What constitutes sound accounting practice is an issue of fact. There is little law about accounting. If a man promises to pay money based on certain operating results, to be

ascertained in accordance with sound accounting practice, the issue of how much is due from him would be almost completely a question of fact. But "indebtedness" and "interest" are very strongly legal conceptions. There is a great deal of law about them and it is far more likely that Congress used these words in the deduction section with reference to the common understanding of their meaning — than that it used them in some new and strange sense,[23] peculiarly related to taxation, which only "an administrative body having special competence to deal with the subject matter would have the insight to interpret and apply." [24]

In the present case, practically all material facts are stipulated. There is a clear, complete and unambiguous instrument to be analyzed and a direct and categorical provision of the statute to be construed and applied to it. There is no evidence or suggestion of the notes being a sham, or temporary expedient or instrumentality for accomplishing an entirely distinct purpose. Hence, no substantial issue of fact is presented upon which a finding supported by evidence would be final.[24] The only dispute of fact which the Tax Court opinion even contemplates is the issue made by the Tax Court with respect to "intent," which upon analysis is nothing but an improper concern with a question of "motive."

The meaning of the words in the deduction section; whether the deduction section is absolute or subject to the reading in of implied exceptions; whether the meaning of the section may be varied by applying a distinction between "loans" and "Capital investments"; whether the notes do or do not evidence debts; whether or not the annual sums agreed to be paid thereon to service the debts are payments of the type which the law knows as interest; whether a complete and

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[23] Cf. *Commissioner* v. *Raphael*, 133 F. 2d 442, 445 (C.C.A. 9th, 1943).

[24] See dissenting opinion of Magruder, J. (R. 105–106)

unambiguous written instrument may be distorted from its true intendment by extrinsic evidence and discussions of "motive"; whether a confusion of "intent" and "motive" is erroneous and prejudicial; whether it may be held that every feature of an instrument is a permissible feature of a debt and yet that all features together make the instrument not a debt, notwithstanding that the central feature is an unqualified promise to pay a fixed sum at a fixed maturity; whether a purported statutory construction, implied in a decision, amounts practically to judicial legislation; whether a particular application of a statute would violate established canons of construction; all these are questions of law and not of fact and on each one of these the Tax Court (and the Circuit Court of Appeals) arrived at an erroneous conclusion or it would not have reached the result it did.

Our position is decisively justified by

Trust u/w Bingham v. *Commissioner of Internal Revenue*, U.S. , 89 L. Ed. 1191 (1945)

in which the power to review the Tax Court on issues of law was reaffirmed with respect to the deduction afforded by I.R.C. § 23 (a) (2).

And there is one further suggestion which we take the liberty of offering, namely that the scope of review of Tax Court decisions ought not to be startlingly unlike the scope of review of United States District Court decisions in tax cases or of Court of Claims decisions in tax cases.

A taxpayer need not pay a deficiency as a preliminary to taking a case to the Tax Court. But the Tax Court is not a court of exclusive jurisdiction. If the taxpayer can raise the money, he may pay the deficiency, claim a refund and sue in the District Court or the Court of Claims.[25]

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[25] I.R.C. §§ 322, 3772; Jud. C. § 24, amended, U.S.C.A. § 41 (5), (20); Jud. C. § 145, U.S.C.A. § 250 (1).

A good deal has been said about the special competency of the Tax Court (e.g. in the *Dobson* case, and in the *Bingham* case, U.S. p. , 89 L. Ed. p. 1200, by the concurring justices). But "special competency" in combination with a non-exclusive jurisdiction of the subject matter does not too strongly suggest that Congress mean to constrain the Circuit Courts of Appeal and this Court in their reviewing functions.

It will be unfortunate if the taxpayer's ability finally to have a lawful application of the tax statute by reviewing courts comes to turn upon the question whether he can raise the money to pay a deficiency. And if taxpayers turn away from the Tax Court and pursue other remedies, because of unreasonable extensions of the *Dobson* case, it will be strange to come to the logical next claim of the government, namely, that Tax Court decisions, *as precedents*, are superior to decisions of this Court or of the Circuit Courts or Court of Claims.

We therefore respectfully submit that the Tax Court decision in this case, involving fundamentally only issues of law, must not find shelter under the *Dobson* case by stretching the conception of what is "fact" to cover them.

Respectfully submitted,

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APPENDIX A.

The rule for resolving doubts in the taxpayer's favor and the rule of "strict construction" of exemptions and the like are not inconsistent upon a proper analysis of the cases supporting the latter "rule."

In a matter of construction, some initial inclination in the taxpayer's favor is to be derived from the rule that tax statutes "in case of doubt . . . are construed most strongly against the government, and in favor of the citizen,"

Gould v. *Gould*, 245 U.S. 151 (1917)

It has been said that this rule has been "modernly more honored in the breach than in the observance,"

Frost Lumber Industries v. *Commissioner*, 128 F. 2d 693, 694 (C.C.A. 5th, 1942)

but the authorities for it are still impressive.[1] It ought, even in cases of deductions, at least to militate against the making

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[1] *Bowers* v. *New York & A. Lighterage Co.*, 273 U.S. 346, 350 (1927); *Crooks* v. *Harrelson*, 282 U.S. 55, 60, 61 (1930); *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 561–2 (1932); *White* v. *Aronson*, 302 U.S. 16, 20 (1937); *Hassett* v. *Welch*, 303 U.S. 303, 314 (1938); *Corporation of America* v. *McLaughlin*, 100 F. 2d 72, 74 (C.C.A. 9th, 1938); *Commissioner* v. *Rabenold*, 108 F. 2d 639, 640 (C.C.A. 2d, 1940); *Partee* v. *Commissioner*, 114 F. 2d 716, 719 (C.C.A. 6th, 1940); *United States* v. *Motsinger*, 123 F. 2d 585, 589 (C.C.A. 4th, 1941); *Feitler* v. *Harrison*, 126 F. 2d 449, 451 (C.C.A. 7th, 1942); *Coleman* v. *United States*, 37 F. Supp. 273, 277 (Ct. Cl. 1941); *Frost Lumber Industries* v. *Commissioner*, cited in text supra; *Mayer* v. *Reinecke*, 28 F. Supp. 334, 339–40 (D.C.N.D. Ill., 1939); *Penn. Co. for Insurances etc.* v. *United States*, 39 F. Supp. 1019, 1022 (D.C.E.D. Pa. 1941).

of strained constructions in the government's favor,[2] doing violence to the well established meaning of the words which Congress has used.

There is presented, nevertheless, the problem of reconciling the principle mentioned above with the principle relating to "strict construction" of exemptions, credits, deductions and the like. Some courts may have deemed the two principles to be incompatible,[3] but we do not believe that such a conclusion is required by any of the decisions of the Supreme Court, which are as follows:

Woolford Realty Co. v. *Rose*, 286 U.S. 319 (1932).
New Colonial Ice Co. v. *Helvering*, 292 U.S. 435 (1934).
White v. *United States*, 305 U.S. 281 (1938).
Deputy v. *DuPont*, 308 U.S. 488 (1940).
Helvering v. *Northwest Steel Rolling Mills*, 311 U.S. 45 (1940).
Helvering v. *Ohio Leather Co.*, 317 U.S. 102 (1942).
Equitable Life Assurance Society v. *Commissioner*, 321 U.S. 560; 88 L. Ed. 927 (1944).

These cases are briefly abstracted hereinafter (pages 46–49 infra) with quotations, in support of what is now to be said with respect to them.

The "rule," of "strict construction" of exemptions or deductions, has been variously applied[4]; and the boundaries

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[2] That was the use actually made of the rule in *Old Colony R. Co.* v. *Commissioner*, cited Note 1, page 44, supra.

[3] *Maloney* v. *Portland Associates*, 109 F. 2d 124 (C.C.A. 9th, 1940).

[4] *Uhl Estate Co.* v. *Commissioner*, 116 F. 2d 403 (C.C.A. 9th, 1940); *Antietam Hotel Corporation* v. *Commissioner*, 133 F. 2d 274, 278 (C.C.A. 4th, 1941); *Commissioner* v. *Hopkinson*, 126 F. 2d 406, 411 (C.C.A. 2d, 1942); *Harwick* v. *Commissioner*, 133 F. 2d 732, 735 (C.C.A. 8th, 1943).

are not always clear between it and the general principle relating to the burden of proof which is always incumbent upon a taxpayer seeking to overcome a deficiency. On the other hand it has been said, even in cases of deductions, that "unjust and oppressive consequences" are to be avoided.[5]

At all events, it will be clear, from an examination of the Supreme Court decisions cited above and hereinafter abstracted, that

(1) The decisions, embodying the general rule of construction in the taxpayer's favor, have never been overruled expressly and by name.

(2) The Court has never used the "rule" of "strict construction" to deprive a taxpayer of the benefit of the fair, plain ordinary meaning of a provision establishing a deduction.

(3) The Court has only used the "rule" to deny claims for the extension or expansion, by implications, of deduction sections, or to refute arguments which would have precluded the Court from exercising its proper judicial function in the resolving of genuine questions of construction.

The cases referred to are as follows:

Woolford Realty Co. v. *Rose* 286 U.S. 319 (1932).

Upon a consolidated return, the taxpayer endeavored to deduct the losses which one of the affiliated corporations had incurred prior to the period of consolidation. In denying this claim the court said in part

"A taxpayer who seeks an allowance for losses suffered in an earlier year must be able to point to a

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[5] *Boston Consolidated Gas Co.* v. *Commissioner,* 128 F. 2d 473, 476 (C.C.A. 1st, 1942); *Helvering* v. *Cannon Valley Milling Co.,* 129 F. 2d 642, 647 (C.C.A. 8th, 1942).

specific provision of the statute permitting the deduction, and must bring himself within its terms." Id. p. 326

New Colonial Ice Co. v. *Helvering*, 292 U.S. 435 (1934). The taxpayer, which had succeeded in reorganization to the business of a predecessor corporation, endeavored to deduct the net losses of such predecessor. The court's language includes

> "Obviously, therefore a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." Id. p. 440

White v. *United States*, 305 U.S. 281 (1938). The issue was whether a particular loss, the existence of which was unquestioned, was deductible in its entirety as an "ordinary" loss or was subject to certain limitations as a "capital" loss. A complicated question of construction was thus afforded, involving a choice between alternative statutory provisions. It would seem that the taxpayer argued that because of "doubt," the construction favoring them should be adopted. The court replied

> "We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be. Here doubts which may arise upon a cursory examination of §§ 101 and 115 disappear when they are read, as they must be, with every other material part of the statute, *Hellmich* v. *Hellman*, supra (276 U.S. 237, 72 L. ed. 546, 48 S. Ct. 244, 56 A.L.R. 379), and in the light of their legislative history. Moreover, every deduction from gross income is

allowed as a matter of legislative grace, and 'only as there is clear provision therefor can any particular deduction be allowed . . . a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.' *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440, 78 L. ed. 1348, 1352, 54 S. Ct. 788." Id. p. 292

Deputy v. *DuPont*, 308 U.S. 488 (1940). The taxpayer claimed to deduct, as a business expense or as "interest," sums which he had paid the lenders of shares of stock as the equivalent of the dividends upon the borrowed shares, all under somewhat special circumstances. The court said

> "But allowance of deductions from gross income does not turn on general equitable considerations. It 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440, 78 L. ed 1348, 1352, 54 S. Ct. 788. And when it comes to construction of the statutory provision under which the deduction is sought, the general rule that 'popular or received import of words furnishes the general rule for the interpretation of public laws,' *Maillard* v. *Lawrence*, 16 How (U.S.) 251, 261, 14 L. ed. 925, 930, is applicable." Id. p. 493.

Helvering v. *Northwest Steel Rolling Mills*, 311 U.S. 45 (1940). The question was whether a state charter of a corporation was "a written contract executed by the corporation" preventing the payment of dividends and permitting a credit under the undistributed profits tax law. The court said that

> "It has been said many times that provisions granting tax exemptions are to be strictly construed." Id. p. 49.

(This is perhaps a little stronger language than the previous cases justified, but the court was endeavoring to make a compact statement of a principle.)

Helvering v. *Ohio Leather Co.*, 317 U.S. 102 (1942). This was another undistributed profits tax case. It was said that since the particular section in question

> "grants a special credit in the nature of a deduction, the taxpayer must sustain the burden of showing compliance with its exact terms." Id. p. 106.

Equitable Life Assurance Society v. *Commissioner*, 321 U.S. 560, 88 L. Ed. 927 (1944). In this case, certain "excess interest dividends" upon insurance policies were held not deductible. Reference was made to

> "the strict rule of construction which has obtained in case of deductions." Id. p. 605.

Yet what the court actually did in this case was to refuse to expand the meaning of "interest" to cover certain amounts which were capable of being declared or withheld at the pleasure of the Board of Directors of the insurance company — "a degree of contingency," as the court said, which the notion of interest ordinarily lacks. Id. p. 605. The word "expand" correctly describes what the court was being asked to do and its reference to the "strict rule of construction" was plainly only by way of contrast.

It will have been observed that each generalization used in the language of the above opinion has been consistent with the proper use, and only inconsistent with the improper extension, of the rule for resolving doubts in the taxpayer's favor.

We believe the whole business comes down to this: The Tax is levied upon *net income* I. R. C. §§ 13 (b); (15) (b) etc. Gross income and deduction are alike but factors in a

formula by which Congress directs the determination of "net income" for tax purposes. No aspect of a tax law should be construed, against a taxpayer, as going beyond the clearly perceptible intendment of the words actually used by Congress. On the other hand, words of exemption, deduction and the like, are not to be extended, in the taxpayer's favor, beyond their natural intendment. There is no common law of income taxation. The citizen is entitled to keep his money unless Congress has actually said he must part with it. And what Congress did say, not what it might have said (or the Commissioner wishes it had said), governs.

APPENDIX B.

Excerpts from MOODY'S MANUAL OF INVESTMENTS, 1943, American & Foreign, Railroad Securities, MOODY'S INVESTORS' SERVICE, 65 Broadway, New York, Page 450.

ERIE RAILROAD COMPANY—General Mortgage Income 4½s, due January 1, 2015

Rating—B

Open Mortgage—Series A, Limited to $54,500,000; outstanding, December 31, 1942, $51,391,215; held by or for Company, $636,710.

DATED—July 1, 1941.

MATURITY—January 1, 2015.

INTEREST—Payable annually April 1 at rate of 4½% per annum, out of available net income, only to extent earned, cumulative to extent earned up to a maximum of 13½% (excluding interest owing as a debt in a given year but paid on interest debts in succeeding year). Accumulated interest up to maximum shall be paid from available net income to extent hereinafter provided, and in any event, whether earned or not, at maturity or redemption of Series A Income Bonds.

Principal and interest payable at Company's New York office in U. S. legal tender.

INTEREST PAYMENTS—Per $1000 bond: April 1, 1942 and 1943, $45.

AVAILABLE NET INCOME—Available net income for each calendar year is after fixed charges of company and its wholly-owned railway subsidiaries on a consolidated basis, without adjustments, except that (1) deficits from

one or more calendar years shall be deducted until such deficit (or accumulated or remaining deficits) be extinguished, and (2) debits and credits to adjust income in prior years shall be treated as income items for the year in which entered on the books, whether cleared through income or profit and loss accounts, so far, but only insofar, as such debits and credits reflect cash receipts or disbursements in the year in which they are entered on the books.

Available net income for each calendar year shall be applied as follows in order shown: (1) capital expenditure fund [see under first consolidated bonds (No. 5)]; (2) an amount equal to lesser of (a) balance of such available net income not applied as above and (b) 10% of principal amount of any emergency bonds issued which shall be applied as a sinking fund payment; (3) sinking fund on first consolidated mortgage bonds; (4) interest on income bonds, also any accumulated unpaid interest (provided that such interest need be paid only in multiples of ¼%); (5) sinking fund on income bonds, series A; (6) sinking fund for income bonds of series other than series A; (7) corporate purposes, including dividends on preferred and common stocks.

The following material, drawn from the indenture itself may show rather more clearly than the above excerpt, the nature of the 13½% "cumulative" provision.

Excerpt from Erie Railroad Company 4½% Income Bond Series A, due January 1, 2015

". . . to pay interest on said sum from the date hereof until the payment of said principal sum at the rate of four and one-half per cent. (4½%) per annum, beginning April 1, 1942, on April 1 of each year thereafter, to and including April 1, 2014, and on January 1, 2015 (in each instance through the December 31 next preceding), and to pay an amount equal to

interest at such rate from January 1, 1940, to the date hereof, *but, except as otherwise provided herein or in the Indenture hereinafter mentioned, only if and to the extent that the amounts applicable thereto under the provisions of the Indenture are sufficient to make such interest payments* and until the maturity of this Bond only upon presentation and surrender of the appropriate coupons as provided in the Indenture. *Unpaid interest will accumulate*[1] *to an amount not exceeding, prior to maturity (exclusive of interest earned as provided in the Indenture but unpaid) 13½% of the principal hereof at any one time and such accumulated interest will be payable thereafter if earned as provided in the Indenture or, in any event, at the maturity of this Bond whether by declaration or otherwise.*" (Italics supplied)

Provisions of Article 5 of the mortgage indenture, too lengthy to quote herein, deal with the determination of "available net income," provide for numerous deductions therefrom for various purposes and state that "any the[illegible]remaining available net income shall be applied to the pay[illegible]f interest on the bonds." Other lengthy provisions may b[illegible]marized as providing that interest for each year shall accrue and become owing as a debt only if and to the extent that the amounts applicable to the payment thereof, under the provisions just mentioned above, shall suffice therefor. The provisions are elaborate and include other restrictions or qualifications of the obligation.

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[1] It will be noted that only three years' unearned interest becomes unqualifiedly payable out of 74 years that the bond has to run to maturity.

APPENDIX C.

Excerpts from Statutes Showing the Liberalization of the Interest Deduction in the case of Corporations Afforded by the Revenue Act of 1918

Revenue Act 1916, Section 5

"Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

Second. All interest paid within the year on his indebtedness;"

Revenue Act 1916, Section 12 (a)

"Sec. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

Third. The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding: *Provided*, That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income: *Provided further*, That in cases wherein shares of capital stock are issued without par or nominal value, the amount of paid-up capital stock, within the meaning of this section, as represented by such shares,

will be the amount of cash, or its equivalent, paid or transferred to the corporation as a consideration for such shares: *Provided further*, That in the case of indebtedness wholly secured by property, collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint-stock company or association as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral: *Provided further*, That in the case of bonds or other indebtedness, which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed, or any other tax paid pursuant to such guaranty, shall be allowed; and in the case of a bank, banking association, loan or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company;"

Revenue Act 1918, Section 234 (a)

"Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a foreign corporation, the proportion

of such interest which the amount of its gross income from sources within the United States bears to the amount of its gross income from all sources within and without the United States;"

APPENDIX D.

Specimen Definitions of the Terms Indebtedness and Interest

Indebtedness: The state of being in debt, without regard to the ability or inability of the party to pay the same . . . . But . . . there must be an actual liability . . . . to pay then or at a future time.—*Bouvier's Law Dictionary, Rawle's Third Revision, Vol. 2, p. 1531.*

"1. State of being indebted. 2. The sum owed; debts, collectively." *Webster's New International Dictionary, Second Edition, Unabridged, Vol. II, p. 1261.*

Indebted: "1. Brought into debt; being under obligation; held to payment or requital; in debt." *Webster, op. cit., Vol. II, p. 1261.*

Debt: "A sum of money due by certain and express agreement." *Bouvier, op. cit. Vol I, p. 786.*

"That which is due from one person to another . . . money . . . that which one person is bound to pay to another . . . an obligation or liability." *Webster, op. cit. Vol. I, p. 678.*

Interest: "On debts. The compensation which is paid by the borrower of money to the lender for its use, *and generally, by a debtor to his creditor in recompense for his detention of the debt.*" *Bouvier, op. cit., Vol. II, p. 1642.* (Italics ours)

"The price or rate of premiums per unit of time that is paid by a borrower for the use of what he borrows; specif. *a rate per cent of money paid for the use of money or the forbearance of demanding payment of a debt.*" *Webster, op. cit., Vol. II, p. 1294.* (Italics ours)